No. 11804

In the United States Circuit Court of Appeals for the Ninth Circuit

KASSON NAME PLATE COMPANY, A CORPORATION, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 31-65) are not reported.

JURISDICTION

The petition for review herein (R. 69-74) involves deficiencies in income taxes, declared value excess profits taxes, and excess profits taxes in the aggregate sum of $12,279.94 for the taxable years ended June 30, 1941, and June 30, 1942, as asserted by the Commissioner in notice of deficiency mailed to the taxpayer on September 21, 1944 (R. 16-29, 68-69). Within ninety days thereafter and on December 11, 1944, the taxpayer filed a petition with the Tax Court of the United States for redetermination of those deficiencies

under the provisions of Section 272 of the Internal Revenue Code. (R. 2, 4-29.) The taxpayer's motion to vacate and set aside the Tax Court's memorandum findings of fact and opinion filed on June 20, 1947 (R. 66-67), was denied by the Tax Court's order entered July 14, 1947 (R. 68), and the final order and decision of the Tax Court partially sustaining the deficiencies in question was entered on July 30, 1947 (R. 68-69). The case is brought to this Court by the taxpayer's petition for review filed November 3, 1947 (R. 69-74), pursuant to the provisions of Sections 1141-1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether there was substantial evidence to support the Tax Court's finding that the bonuses paid the taxpayer's two officers in proportion to their stockholdings were not, when considered together with their regular salaries and other compensation paid them, reasonable compensation for personal services rendered, within the meaning of the statute.

STATUTE AND REGULATIONS INVOLVED

The statute and Regulations involved will be found in the Appendix, *infra*.

STATEMENT

The facts pertaining to the issue involved herein were found by the Tax Court as follows (R. 34-41): [1]

The taxpayer is a corporation. It was incorporated under the laws of the State of California on August 19, 1923, and has its principal office and place of business in the City of Los Angeles. It filed its corporation income and excess profits tax returns for the fiscal years ended June 30, 1941, and June 30, 1942, with the Collector for the Sixth Collection District of Los Angeles. (R. 34.)

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[1] The facts found by the Tax Court in respect to another issue not involved herein (R. 41-52, 59-65) have been omitted from the Statement.

Joseph W. Hayek has been in the name plate business since 1907. From 1907 to 1917 he either managed name plate companies or the name plate departments of various companies. In 1917 he started a name plate business in Minneapolis, Minnesota, under the name of Hayek Nameplate & Novelty Company. In 1921 he sold this business to William James Kennedy and Kennedy's uncle. Kennedy and his uncle moved the business to Los Angeles, California, and began to operate it as a partnership under the name of Kennedy Nameplate Company. Hayek originally became an employee of the partnership and had charge of the production end of the business. Soon thereafter Kennedy's uncle sold his 50% interest in the partnership to Hayek and in 1923 Hayek and Kennedy organized the taxpayer herein. The business of the partnership was transferred to the taxpayer in exchange for the latter's stock. From the time of organization to and through the taxable years here involved Hayek has been the president and a director of the taxpayer and Kennedy has been the secretary-treasurer and a director. Both men have devoted their entire time to the taxpayer's business and have engaged in no outside business activities. (R. 35.)

At the time the taxpayer was organized it issued 1,251 shares of its stock to Hayek, 1,251 shares to Kennedy and 1 share to a Mr. Frank who became a director along with Hayek and Kennedy. The taxpayer had only three directors. Frank was later succeeded by D. R. Koelling who then became the third director. The stock had a par value of $10 per share. During the taxable years here in question the stock that was issued to Hayek was owned by him as his separate property and the stock that was issued to Kennedy was either owned by him as his separate property or by him and his wife, Alice L. Kennedy, as community property. (R. 35-36.)

Kennedy was employed by various companies in New York

City, Chicago, and in South America from 1912 to 1921 when he first engaged in the name plate business. He had had quite extensive experience as an executive and manager and in sales promotion both in the United States and in South America. (R. 36.)

From the time that the taxpayer was organized to and through the taxable years here involved Hayek and Kennedy divided the important managerial functions of taxpayer's business between them. Hayek was in complete charge of production, supervising the work of men employed in several different trades including art, die making, engraving, photography, etching, plating, lithography, decalcomania manufacture and punch press operations. He also employed a portion of the technical personnel. He perfected many new processes and techniques including a new method for camera work, the elimination of certain etching and lithographic operations, die making improvements, new engraving methods, new chemical solutions and new uses for chemical solutions, new processes for plastics and fibre, fluorescent plates and many others. He and Kennedy together devised a new type of conveyor to operate under a bank of infra red light which has been quite successful. Kennedy was in complete charge of all departments and activities of the taxpayer except production, including sales, advertising, price figuring, employment of a portion of the technical personnel, collections, purchases, finances and also keeping in constant touch with new technological developments and processes. (R. 36-37.)

During the taxable years ended June 30, 1941, and June 30, 1942, Hayek worked from 65 to 75 hours per week as compared with about 45 hours in 1939. Many times he worked on Sunday during the war and more than once he was required to work all night on important war jobs.

Kennedy worked about 54 hours per week during the taxable years as compared with about 45 hours per week during 1939 and 1940. (R. 37.)

The business of the taxpayer during the years 1941 and 1942 included the production of many items in addition to name plates, including scales, dials, instruction and designation plates, luminous, fluorescent and phosphorescent plates and other articles of similar nature which were sold largely to the airplane industry. It was necessary to substitute plastics and fibres for metals in manufacturing many products because of the shortage of metals and the necessity for conserving strategic materials. The business of the company during these years also involved the use of radium and black light. Many problems arose due to the fumes caused by the use of certain materials, allergies and radioactivity. Government inspection during the war was very rigid, requiring greater accuracy in production than in prior years. (R. 37-38.)

The by-laws of the taxpayer empowered the board of directors to appoint and remove all officers of the company, prescribe their duties and fix their compensation. (R. 38.)

The minutes of the regular meeting of the board of directors of the taxpayer held on April 30, 1940, provide in part as follows (R. 38):

> On motion of Jos. W. Hayek, seconded by D. R. Koelling, it was voted to increase the salary of W. J. Kennedy, to $12,000 per year, retroactive to July 1st, 1939.
>
> W. J. Kennedy then relinquished the chair to Jos. W. Hayek, and moved, seconded by D. R. Koelling, that the salary of Jos. W. Hayek be increased to $12,000 per year, retroactive to July 1st, 1939.

The minutes of the regular meeting of the board of directors of the taxpayer held on June 11, 1941, provide in part as follows (R. 38):

> On motion of W. J. Kennedy, seconded by D. R. Koelling, a bonus of $5,000 was voted to Jos. W. Hayek and W. J. Kennedy.

The taxpayer's net sales, officers' compensation (Hayek and Kennedy only), net income before federal taxes on income, federal taxes on income, and net profits for the fiscal years ended June 30, 1936, to June 30, 1942, inclusive (R. 38-39), were as follows (R. 39):

Year Ended June 30	Net Sales	Officers' Compensation	Net Income before Federal Taxes	Federal Taxes on Income	Net Profit
1936	$82,153.49	$6,542.00	$16,430.61	$2,925.79	$13,504.82
1937	98,354.42	15,000.00	13,870.53	2,961.67	10,908.86
1938	109,464.23	15,322.40	6,387.47	1,526.50	4,860.97
1939	109,966.49	15,183.30	10,164.23	1,347.99	8,816.24
1940	151,446.43	24,194.80	15,862.53	2,145.75	13,716.78
1941	256,451.30	34,000.00	46,942.07	16,709.61	30,232.46
1942	363,912.88	34,000.00	91,747.72	50,597.47	41,150.25

Beginning in 1931 the taxpayer began paying bonuses to certain of its employees. During the taxable years such bonuses approximated $12,000 to $14,000 per year. During the fiscal years ended June 30, 1937, to June 30, 1942, inclusive, the taxpayer's employees numbered 39, 36, 37, 53, 73 and 90, respectively. (R. 39.)

The taxpayer accumulated certain scrap from time to time which is the metal that was left over from the various jobs. It is usually referred to as "overs on jobs" and is sold as scrap. The proceeds from the sales of scrap by the taxpayer amounted to $1,873.16 for the fiscal year ended June 30, 1941, and $1,716.36 for the fiscal year ended June 30, 1942. One-half of these amounts was paid over to Hayek and one-half to Kennedy, who, together with their respective wives, reported the amounts in their

individual income tax returns as income from the sale of scrap. The taxpayer did not return any of the proceeds from the sales of scrap as income and neither did it deduct any amount as compensation, or otherwise, on account of the proceeds that were paid over to Hayek and Kennedy. The proceeds from the sale of scrap were a part of the taxpayer's gross income and should have been returned by the taxpayer as such. It is the practice in the name plate industry to permit officers to sell scrap and to regain the proceeds from such sales as a bonus or additional compensation. Everywhere that Hayek ever worked he always got the scrap or part of the scrap. In 1916, when he was working for a Minneapolis concern, his salary was $4,420 plus all the scrap except the scrap from sterling silver. In 1930 he was offered a position at an annual salary of $12,000 plus 20% of the scrap. (R. 39-40.)

During the years 1941 and 1942 there were only two or three firms besides the taxpayer in the name plate business in the Los Angeles area. The principal competitor of the taxpayer in the Los Angeles area was Miller Dial & Nameplate Company. During the years 1941 and 1942 Miller Dial & Nameplate Company was a partnership composed of two brothers, Charles W. Miller and John Dawson Miller. The duties of Charles in the partnership were very similar to those of Kennedy in the taxpayer company and the duties of John in the partnership were very similar to those of Hayek in the taxpayer company. The sales of Miller Dial & Nameplate Company for the calendar year 1941 were approximately $150,000 and for the calendar year 1942 they were approximately $338,000. No salaries were paid to the partners in Miller Dial & Nameplate Company for the year 1941; the partners simply made withdrawals as needed. For the year 1942 the salary of

Charles was $24,000 and that of John was $18,000. (R. 40-41.)

During February or March of the year 1943 the Northern Engraving Company of Racine, Wisconsin, offered to purchase a 51% control of the business of the taxpayer and to retain the services of Hayek and Kennedy for a period of two years. This offer was rejected. (R. 41.)

The taxpayer has declared or paid no dividends, as such, since the fiscal year ended June 30, 1938. (R. 41.)

A reasonable allowance for salaries or other compensation for personal services actually rendered to the taxpayer by each of its officers, Hayek and Kennedy, during each of the taxable years ended June 30, 1941, and June 30, 1942, was the basic salary paid to each officer in each year in the respective amount of $12,000 plus the proceeds from the sale of scrap in each of the taxable years paid to those two respective officers. The amounts of $5,000 paid to each officer in the taxable years ended June 30, 1941, and June 30, 1942, were in the nature of dividend distributions on stock. (R. 41).

Upon the basis of the foregoing facts the Tax Court, affirming in part the Commissioner's determination (R. 16-29), found and held that the bonus payments in question aggregating $10,000 for each of the taxable years involved were in the nature of dividend distributions on stock and therefore were not deductible as ordinary and necessary business expenses for those years (R. 41, 52-59), and thereupon entered its decision accordingly (R. 68-69). From the decision so entered the taxpayer petitioned this Court for review. (R. 69-74.)

SUMMARY OF ARGUMENT

The Tax Court properly allowed the taxpayer to deduct only a reasonable portion of the total sum paid to its president and secretary-treasurer as salaries, bonuses and other

compensation for the taxable years ended June 30, 1941, and June 30, 1942, and disallowed the remainder (bonuses) as being in reality dividend distributions of profits and therefore not deductible as business expenses. The question presented is one of fact, and since there is substantial evidence to support the Tax Court's findings and decision they should be affirmed upon review.

The facts show that the taxpayer was a closely held corporation completely controlled and dominated by the two officers in question who, barring one qualifying share, owned equal shares of all the taxpayer's outstanding stock, that no dividends were declared or paid during the taxable years or for several years prior thereto, and that the increased compensation they voted themselves as directors and officers of the corporation and received as bonuses in those years, actually represented corporate earnings. Under these circumstances it is apparent that the excessive sums paid them as bonuses were in fact distributions of profits. Accordingly, the bonuses in question, over and above the salaries and other compensation allowed by the Tax Court as reasonable, may not properly be considered as reasonable allowances for services actually rendered during the taxable years and deducted as business expenses.

ARGUMENT

The Tax Court's findings as to the amounts in question which constituted unreasonable compensation paid as bonuses to the taxpayer's officers are supported by substantial evidence and should therefore be sustained

The answer to the question herein turns on the decision as to whether the amounts in controversy, aggregating $10,000 and representing payments made by the taxpayer as bonuses, in addition to the regular salaries and other compensation, to its president and secretary-treasurer during each of the taxable years ended June 30, 1941, and June 30, 1942, and disallowed by the Commissioner and the Tax

Court as unreasonable, constituted, over and above the sums allowed as deductions, "a reasonable allowance for salaries or other compensation for personal services actually rendered" during those years, within the meaning of the statute and the Regulations. Section 23 (a) (1) (A) of the Internal Revenue Code, as amended (Appendix, *infra*); Sections 19.23 (a)-1, 19.23 (a)-6, and 19.23 (a)-8 of Treasury Regulations 103 (all Appendix, *infra*). If so, the statute authorizes the deduction thereof as ordinary and necessary expenses paid or incurred during the taxable years in carrying on the taxpayer's trade or business (Section 23 (a)(1) (A)); otherwise, deduction of the excess amounts disallowed as unreasonable is unauthorized.

The applicable Treasury Regulations of long standing provide that the allowance "may not exceed what is reasonable under all the circumstances", and that, in general, reasonable compensation constitutes "only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Section 19.23 (a)-6 (3), Treasury Regulations 103.

It is established by numerous decisions of this Court and the other Circuit Courts of Appeals that the question of reasonableness of salaries or other compensation claimed as deductions is purely one of fact; that the taxpayer has the burden of proving that the Commissioner's determination, presumptively correct, is wrong; and that the Tax Court's finding of the amount constituting reasonable compensation is entitled to finality if supported by substantial evidence.[2] These decisions are merely applications of

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[2] *E. Wagner & Son* v. *Commissioner,* 93 F. 2d 816, 818 (C.C.A. 9th; *Sunset Scavenger Co.* v. *Commissioner,* 84 F. 2d 453, 456 (C.C.A. 9th); *General Water Heater Corp.* v. *Commissioner,* 42 F. 2d 419, 420 (C.C.A. 9th); see also, for example, *Westmoreland Specialty Co.* v. *Burnet,* 57 F. 2d 615 (App. D. C.), certiorari denied, 287 U. S. 609; *L. E. Pinkham Med. Co.* v. *Commissioner,* 128 F. 2d 986, 990 (C.C.A. 1st), certiorari denied,

the familiar principles governing the scope of judicial review of the Tax Court's factual determination.[3] As stated by the Supreme Court in *Wilmington Co.* v. *Helvering,* 316 U. S. 164, 168:

> It is the function of the Board, not the Circuit Court of Appeals, to weigh the evidence to draw inferences from the facts, and to choose between conflicting inferences. The court may not substitute its view of the facts for that of the Board. Where the findings of the Board are supported by substantial evidence they are conclusive.

The appellate court will merely examine the evidence to see whether the Tax Court's findings are supported by substantial evidence, and it need go no further than look into the evidence to ascertain whether it is "legally sufficient to sustain" the findings. *Phillips* v. *Commissioner,* 283 U. S. 589, 600; *Tracy* v. *Commissioner,* 53 F. 2d 575, 578 (C.C.A. 6th). Thus, unless there is no rational basis in the evidence for the Tax Court's conclusion, this Court is

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317 U. S. 675; *L. & C. Mayers Co.* v. *Commissioner,* decided November 3, 1941 (1941 P-H B.T.A. Memorandum Decisions, par. 41,489), affirmed *per curiam,* 131 F. 2d 309 (C.C.A. 2d), certiorari denied, 318 U. S. 773; *Long Island Drug Co.* v. *Commissioner,* 111 F. 2d 593, 594 (C.C.A. 2d), certiorari denied, 311 U. S. 680; *In re Rae's Estate,* 147 F. 2d 204, 207-208 (C.C.A. 3d); *Anthony P. Miller, Inc.* v. *Commissioner,* 164 F. 2d 268, 270 (C.C.A. 3d); *Miller Mfg. Co.* v. *Commissioner,* 149 F. 2d 421, 423 (C.C.A. 4th); *Crescent Bed Co.* v. *Commissioner,* 133 F. 2d 424, 426 (C.C.A. 5th); *Clinton Co.* v. *Commissioner,* 159 F. 2d 102 (C.C.A. 7th); *Helvering* v. *Superior Wines & Liquors,* 134 F. 2d 373, 378 (C. C. A. 8th); cf. *Hecht* v. *United States,* 54 F. 2d 968 (C.Cls.), certiorari denied, 286 U. S. 560.

[3] *John Kelley Co.* v. *Commissioner,* 326 U. S. 521; *Commissioner* v. *Flowers,* 326 U. S. 465, rehearing denied, 326 U. S. 812; *Boehm* v. *Commissioner,* 326 U. S. 287, rehearing denied, 326 U. S. 811; *Commissioner* v. *Court Holding Co.,* 324 U. S. 331; *Commissioner* v. *Scottish American Co.,* 323 U. S. 119; *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231; *Wilmington Co.* v. *Helvering,* 316 U. S. 164; *Helvering* v. *Kehoe,* 309 U. S. 277; see *Commissioner* v. *Heininger,* 320 U. S. 467, 475.

required to affirm its decision on such issue. *Boehm* v. *Commissioner,* 326 U. S. 287, rehearing denied, 326 U. S. 811.

Moreover, in deciding this question, the Tax Court must necessarily exercise its own judgment, and will not be required to ascertain a reasonable allowance with mathematical precision. *Tumwater Lumber Mills Co.* v. *Commissioner,* 65 F. 2d 675 (C.C.A. 9th); *Atlas Plaster & Fuel Co.* v. *Commissioner,* 55 F. 2d 802, 804 (C.C.A. 6th). Since profits may be distributed as salary, extra compensation, a bonus, etc., it is proper to inquire whether the payments are in fact compensation for services actually rendered or are in whole or in part merely distributions of profits. *Botany Mills* v. *United States,* 278 U. S. 282, 292; *Marble & Shattuck Chair Co.* v. *Commissioner,* 39 F. 2d 393 (C.C.A. 6th); *Twin City Tile & M. Co.* v. *Commissioner,* 32 F. 2d 229 (C.C.A. 8th). The credibility of the witnesses, and the weight to be accorded to their testimony and the other evidence adduced at the trial, are matters which were clearly within the province of the Tax Court to determine, for the Tax Court was not required to accept the opinion evidence of the taxpayer's witnesses as to the reasonableness of the salary paid, if it did not see fit to accept such evidence. *Sunset Scavenger Co.* v. *Commissioner,* 84 F. 2d 453 (C.C.A. 9th); *E. Wagner & Son* v. *Commissioner,* 93 F. 2d 816 (C.C.A. 9th); *L. & C. Mayers Co.* v. *Commissioner,* 131 F. 2d 309 (C.C.A. 2d), certiorari denied, 318 U. S. 773; *In re Rae's Estate,* 147 F. 2d 204, 207 (C.C.A. 3d); *Am-Plus Storage B. Co.* v. *Commissioner,* 35 F. 2d 167 (C.C.A. 7th). Also, the Tax Court's findings may not be set aside on appeal because of a difference of opinion as to the weight of the evidence, and its decision based thereon should be sustained if there is any substantial evidence to support it. *Botchford* v. *Commissioner,* 81 F. 2d 914 (C.C.A. 9th); *General Water Heater Corp* v. *Commis-*

sioner, 42 F. 2d 419 (C.C.A. 9th); *L. E. Pinkham Med. Co.* v. *Commissioner*, 128 F. 2d 986 (C.C.A. 1st), certiorari denied, 317 U. S. 675.

Accordingly, the issue here reduces itself simply to a determination of whether or not there is any substantial evidentiary support for the Tax Court's finding that (R. 41):

> A reasonable allowance for salaries or other compensation for personal services actually rendered to petitioner by each of its officers, Hayek and Kennedy, during each of the taxable years ended June 30, 1941, and June 30, 1942, was the basic salary paid to each officer in each year in the respective amount of $12,000 plus the proceeds from the sale of scrap in each of the taxable years paid to those two respective officers. The amounts of $5,000 paid to each officer in the taxable years ended June 30, 1941, and June 30, 1942, were in the nature of dividend distributions on stock.

We submit and show hereinafter that these ultimate findings are amply supported by the record and that, as is plain from its opinion (R. 52-59), the Tax Court weighed all the relevant factors, including those favorable as well as those unfavorable to the taxpayer, in arriving at its decision.

In the first place, upon the Commissioner's determining what portion of the increased amount paid the taxpayer's two officers constituted reasonable compensation for the services actually rendered by them, the taxpayer can prevail only upon a showing that the evidence fairly establishes that the claimed larger amounts were reasonable under all the circumstances, that such amounts were intended and paid as compensation for services, and that the extra compensation was such as would ordinarily have been paid by similar corporations or business enterprises to corresponding officers or employees for like services under like circumstances. Sections 19.23 (a)-6 and 19.23 (a)-8, Treas-

ury Regulations 103; *Botany Mills* v. *United States, supra; Welch* v. *Helvering,* 290 U. S. 111, 115; *L. & C. Mayers Co.* v. *Commissioner,* decided November 3, 1941 (1941 P-H B.T.A. Memorandum Decisions, par. 41,489), affirmed *per curiam,* 131 F. 2d 309 (C.C.A. 2d), certiorari denied, 318 U. S. 773. The taxpayer has failed to meet these requirements.

In the foregoing cases and many others it has been recognized that where a corporation makes a payment to an officer who is also a stockholder and seeks to deduct the amount as compensation for services in computing the tax, it is open to inquiry whether the payment is in fact compensation or is in whole or in part merely a distribution of profits. In the *Botany Mills* case, *supra,* the Supreme Court said (p. 292):

> We do not find it necessary to determine here whether the amounts paid by a corporation to its officers as compensation for their services cannot be allowed as "ordinary and necessary expenses" within the meaning of Section 12 (a), merely because, and to the extent that, as compensation, they are unreasonable in amount. However, this may be, it is clear that extraordinary, unusual and extravagant amounts paid by a corporation to its officers in the guise and form of compensation for their services, but having no substantial relation to the measure of their services and being utterly disproportioned to their value, are not in reality payment for services, and cannot be regarded as "ordinary and necessary expenses" within the meaning of the section; and that such amounts do not become part of the "ordinary and necessary expenses" merely because the payments are made in accordance with an agreement between the corporation and its officers.

The Commissioner disallowed all but the regular salaries and the Tax Court, holding that the bonuses were in the

nature of dividend distributions on stock, disallowed only the bonuses as unreasonable. (R. 33, 41, 52-59.) The taxpayer contends, however, that the Tax Court erred in failing to allow as deductions the total amounts paid its two officers as salaries, bonuses and proceeds from scrap sales which allegedly represented reasonable compensation for personal services actually rendered. It states that this is shown by the taxpayer's statistical data for earnings and the testimony of disinterested and competent witnesses. (Pet. Br. 14-17, 30-32.) It contends further that the Tax Court also erred in holding that the bonus payments of $10,000 to those officers in each taxable year were in the nature of dividend distributions and therefore not deductible as business expenses (Br. 18-19), the Tax Court having erroneously failed to give proper weight and credit to the action of the taxpayer's board of directors voting the bonuses to such officers (Br. 28-29).

As to the resolution of the taxpayer's board of directors, the amount of salary and other compensation fixed by the corporate directors' resolution is presumptively valid but it is not conclusively so. *Becker Bros.* v. *United States*, 7 F. 2d 3 (C.C.A.2d); *H. L. Trimyer & Co.* v. *Noel*, 28 F. 2d 781 (E.D.Va.). Neither was the testimony of the taxpayer's witnesses binding since the Tax Court was free to reject their opinion evidence if it did not see fit to accept it, as heretofore shown. The Tax Court was at liberty to weigh all the evidence and relevant factors, as it did, and thereby arrive at the ultimate findings that the regular salaries of $24,000 paid the two officers, plus the proceeds from the scrap sales, constituted a reasonable allowance for their services actually rendered during the taxable years, and that the $10,000 paid them additionally as bonuses during those years were in the nature of dividend distributions, and therefore not deductible as business ex-

penses paid in the guise of compensation for services. (R. 41, 57-59.) The primary findings (R. 34-41) upon which these findings were based are amply supported by the evidence (R. 76-162), and show conclusively that the excess compensation paid the two officers in the form of bonuses was unreasonable and in any event not deductible as business expenses because it represented distributions of profits.

A consideration of all the facts and surrounding circumstances leads irrefragably to the conclusion that the aggregate salaries and other sums paid as compensation to the taxpayer's two officers in the taxable years represented, in part at least, unreasonable compensation for services rendered, and that a reasonable compensation for such services during those years was not more than $12,000 each, the same as paid in the prior year, plus the proceeds from the scrap sales, as the Tax Court held. (R. 58-59.) The prior years' salaries compared with those of the taxable years, the absence of any declaration and payment of dividends after the fiscal year ended June 30, 1938, and the resolutions of the taxpayer's only two directors and stockholders (barring one qualifying share) two months before the beginning of the taxable years increasing retrospectively their own compensation as officers from $12,000 each in the prior year to an amount in excess of $17,000 each for the taxable years, all tend to show this. The taxpayer has failed to show any justification for an increase, over the prior year, in excess of that determined in part by the Commissioner and as redetermined in greater amount by the Tax Court. (R. 41, 58-59.) There is no evidence whatever to show that the taxpayer's increases in sales for the taxable years over the preceding years (R. 39) were the result of increased effort or ability on the part of the two officers, or that they were not the direct result of the unusual market conditions and commercial prosperity then prevail-

ing because of the war conditions. World War II was then in progress and it is common knowledge that from that time on there was an insatiable demand and ready market for practically any and all manufactured products without much, if any, necessity for selling effort. The evidence shows that the taxpayer's business was materially enhanced to unprecedented proportions during the taxable years by the manufacture and sale of war materials.[4] (R. 95, 97-99, 101, 108, 116-117, 125.) The two officers in question were paid increases during the taxable years in excess of 59% over the preceding year 1940 and much greater increases over 1939 and prior years (R. 39, 58), and the portion of the increases (bonuses) disallowed is not shown to have been justified as reasonable compensation upon the basis of any such factors as increases in sales effected by the efforts of the two officers. Hence, the taxpayer has not shown and the record does not show on what basis the two officers in question received the bonuses during the taxable years. The additional payments were merely determined and fixed by the taxpayer's board of directors of which the two officers—together with Mr. Koelling who owned only one qualifying share—were the only members, and they voted themselves the bonuses. (R. 35-36, 38.) This is a significant factor not to be overlooked in considering the reasonableness and consequently deductibility of their com-

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[4] The evidence shows (R. 98) that in reply to the question, "Was that [war] business increased in 1941 and 1942 over prior years?" witness Kennedy replied "We had an amazing increase." He also testified (R. 108) that in 1941-1942 "we were still completing a lot of commercial business, and going right into war business, and he [Mr. Hayek] was doing twice as much work a part of that time"; and that (R. 117) "the commercial business was becoming less and the military business was increasing, and at the end of 1942 they had practically eliminated the commercial producer, making goods for the commercial producer." Likewise, witness Miller (R. 142), in answer to the question "whether or not the major portion of the increase in business of nameplate companies generally was due to the war activity", stated, "I believe it was."

pensation. *L. & C. Mayers Co.* v. *Commissioner,* decided November 3, 1941 (1941 P-H B.T.A. Memorandum Decisions, par, 41,489), affirmed *per curiam,* 131 F. 2d 309 (C.C.A.2d), certiorari denied, 318 U. S. 773.

The test of deductibility in the case of salaries, bonuses and other compensation is whether they were reasonable and were in fact payments purely for services. Ostensible additional compensation paid by a corporation having a few stockholders who draw salaries invites scrutiny, and in any event the allowance for compensation paid may not exceed what was reasonable under all the circumstances (Sections 19.23 (a)-6 and 19.23 (a)-8 of Treasury Regulations 103), as the Tax Court stated (R. 55). Applying this test to the facts herein, it is at once apparent that the Tax Court properly found and held upon the evidence that the bonuses paid to the two officers were in fact in the nature of dividend distributions on stock, and therefore not deductible as business expenses over and above the regular salaries and the proceeds from scrap sales paid them. (R. 41, 57-58.) Although the taxpayer had large increases in surplus during the taxable years over the preceding years (R. 42-44), the Tax Court found upon the evidence that the taxpayer had declared and paid no dividends, as such, since the fiscal year ended June 30, 1938, when it paid a 20% dividend of $5,006 (R. 41, 56); and that during that year it paid its two officers compensation slightly in excess of $15,000 and had net profits, after deduction of federal taxes, of approximately $4,860 (R. 39, 56). Thereafter the taxpayer's net profits, after taxes were deducted, increased substantially from year to year but the taxpayer nevertheless failed to declare and pay dividends. Instead, it progressively increased the compensation paid its only two officers who, barring one qualifying share, owned 50% each of all the taxpayer's stock, until their combined increases in compensation eventually became the equivalent

of substantial dividends on the outstanding stock during all the non-dividend years (R. 39), as the Tax Court pointed out (R. 56-57). It is quite apparent from these facts, therefore, that the bonus payments were not in fact payments purely for services and reasonable under all the circumstances but that they actually represented distributions of profits in the guise of compensation during the taxable years. *Botany Mills* v. *United States, supra,* p. 292; *H. Levine & Bros.* v. *Commissioner,* 101 F. 2d 391, 393 (C.C.A.7th); *Am-Plus Storage B. Co.* v. *Commissioner,* 35 F. 2d 167 (C.C.A.7th); *Twin City Tile & M. Co.* v. *Commissioner,* 32 F. 2d 229 (C.C.A.8th); *Marble & Shattuck Chair Co.* v. *Commissioner,* 39 F. 2d 393 (C.C.A. 6th); *Drawoh, Inc.* v. *Commissioner,* 28 B.T.A. 666, 682, petition for review dismissed, without opinion, 74 F. 2d 1012 (C.C.A.7th). Consequently, for purposes of taxation, the bonuses must be treated as dividend payments made by the taxpayer and not as business expenses for which deductions may be taken. *Tumwater Lumber Mills Co.* v. *Commissioner,* 65 F. 2d 675, 677 (C.C.A.9th); *Chattanooga Sav. Bank* v. *Brewer,* 17 F. 2d 79 (C.C.A. 6th), certiorari denied, 274 U.S. 751; *R. L. Heflin, Inc.* v. *United States,* 58 F. 2d 482, 486-487 (C. Cls.), certiorari denied, 287 U. S. 631.

It has been held that when a corporation in the normal course of business consistently pays out large portions of its profits as compensation to its officers who are the principal stockholders, such distribution is one of profit rather than an "ordinary and necessary" expense of business. *H. Levine & Bros.* v. *Commissioner, supra,* pp. 393-394. The fact that the salaries, bonuses and other compensation paid to its two officers by the taxpayer were in direct proportion or substantially so to their stockholdings is strong evidence of intent to distribute profits as salaries and other compensation. This must be overcome by clear evidence showing that such compensation was

reasonable in amount and actually represented compensation purely for personal services rendered, barring which it must be disallowed as a deduction for business expense. *General Water Heater Corp.* v. *Commissioner,* 42 F. 2d 419, 420 (C.C.A. 9th); *Bridges-Smith Co.* v. *Glenn* (W.D.Ky.), decided March 18, 1939 (24 A.F.T.R. 1212), affirmed *per curiam,* 116 F. 2d 934 (C.C.A. 6th); *Woodcliff Silk Mills* v. *Commissioner,* 1 B.T.A. 715, 718. Additional compensation to officer-stockholders may properly be disallowed or reduced where the circumstances show that the increase was intended to absorb an anticipated expansion of earnings rather than the payment for additional services rendered. Section 19.23 (a)-7 of Treasury Regulations 103; *Walts, Inc.* v. *Commissioner,* decided January 17, 1947 (1947 P-H T.C. Memorandum Decisions Service, par. 47,003) now pending in this Court.

The only fact apparently adduced by the taxpayer in an attempt to justify the claimed deduction was the increase in its net sales for the taxable years.[5] (R. 39.) While there was a substantial increase in the sales for each year (R. 39), that factor, while relevant, is by no means in itself conclusive of the reasonableness of the total amounts paid the two officers as compensation during those years. *Clinton Co.* v. *Commissioner,* 159 F. 2d 102 (C.C.A. 7th); *Long Island Drug Co.* v. *Commissioner,* 111 F. 2d 593 (C.C.A. 2d), certiorari denied, 311 U. S. 680. Especially is this true where the increase in sales is not shown to have been attributable to the officers' increased services but rather the direct result of the unusual market conditions and commercial prosperity then prevailing generally due to the

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[5] The showing of the two officers' increased hours of work in the taxable years as compared with those of prior years is well taken care of by the increases in the basic salaries. (R. 39.) It should also be noted that the bonuses were not paid in proportion to the respective increases in time worked but in proportion to stockholdings.

unprecedented war demands. (R. 95, 97-99, 101, 108, 116-117, 125.) Cf. *Miller Mfg. Co.* v. *Commissioner,* 149 F. 2d 421, 423 (C.C.A. 4th).

The fact that the taxpayer's financial condition and volume of business continued to improve steadily during the taxable years over prior years does not in any sense require the conclusion that the amounts paid as bonuses to the two officers were no more than reasonable for the services rendered. The same reasoning would be equally applicable to justify *any* amounts of increase in compensation. Quite clearly the stockholding officers would have found it not a little difficult to explain to the other stockholders—if there had been any other than the two officers in question—that it was reasonable steadily to increase their own compensation from year to year commensurate with the taxpayer's increased earnings while paying no dividends as in the taxable years when their compensation was much greater than ever before.

In closely held corporations such as the taxpayer, just as in family corporations, one of the principal criteria in determining reasonableness of officers' salaries and other compensation is whether a stranger's services would be worth the amount claimed as deductions and whether a similar enterprise or a competitor in a like business would place like value on such services. Section 19.23 (a)-6 of Treasury Regulations 103; *L. & C. Mayers Co.* v. *Commissioner, supra.* While comparative salaries are important and material in controversies involving the reasonableness of salary deductions, the taxpayer's contention (Br. 30-32) that the Tax Court erred in failing to give full weight to the testimony of its witness in respect of the business of its only competitor of a size comparable with the taxpayer, is without avail. We have already shown that it is entirely within the province and discretion of the Tax Court to deter-

mine what weight, if any, is to be accorded the testimony of witnesses and the other evidence adduced at the trial, and that it may accept or reject such evidence as it sees fit. Amounts paid by similar enterprises for services of like character furnish a guide but not a rule. *William S. Gray & Co.* v. *United States,* 35 F. 2d 968, 973 (C. Cls.). Moreover, the comparative data and statistics adduced by the taxpayer's witness could not be given the weight contended for by the taxpayer because the alleged similar enterprise was a partnership and not a corporation. Therefore, it could have distributed all its earnings in the form of salaries and compensation among the partners without regard to tax consequences. But, as the Tax Court pointed out (R. 57-58), this is not true in the case of a corporation where it is very important for tax purposes whether the payments were in fact for services actually rendered and were reasonable under all the surrounding circumstances, as required by the statute and the Regulations.

We think that *Capitol-Barg Dry Clean. Co.* v. *Commissioner,* 131 F. 2d 712 (C.C.A. 6th), relied upon principally by the taxpayer (Br. 15-17, 29, 32), was decided erroneously since it is inconsistent with the decisions of this Court and the many other courts above cited. In that case the court held that since the evidence showed that the work of the taxpayer's two principal officers resulted in profitable business and in the opinion of disinterested witnesses who were familiar with such business the compensation payments were fair and reasonable, the salaries and bonuses paid them were deductible as claimed. That holding, however, is inconsistent with this Court's decision in such cases as *Doernbecher Mfg. Co.* v. *Commissioner,* 95 F. 2d 296, for example, which affirmed the decision of the Board of Tax Appeals ascertaining and fixing the reasonable allowance as compensation of the officers of the taxpayer corporation,

and is a complete answer to all of the taxpayer's contrary contentions herein. This Court there held (p. 299) that where all the facts were before the Board, as was the case there, the fixing of the amount of reasonable necessary expenditures rested exclusively with the Board and for that reason the Court could not substitute its own judgment on that matter even if it were disposed to do so.

We have not reviewed the several other cases cited by the taxpayer since the question of what constitutes reasonable salaries and other compensation depends upon the facts in each particular case. *H. Levine & Bros.* v. *Commissioner, supra,* p. 393. As this Court, quoting from *Atlas Plaster & Fuel Co.* v. *Commissioner,* 55 F. 2d 802, 804 (C.C.A. 6th), stated in *Tumwater Lumber Mills Co.* v. *Commissioner, supra,* p. 677, with reference to cases of this kind: "Every case must stand upon its own peculiar facts and circumstances." Therefore, the many rulings and decisions in which such compensation has been determined can have no particular value as precedents herein.

Finally, we submit that there is no merit to the taxpayer's contention that the Tax Court erred in denying its motion to vacate and set aside the memorandum findings of fact and opinion (R. 66-68) because the Tax Court had not complied with the provisions of the Administrative Procedure Act, c. 324, 60 Stat. 237. The taxpayer erroneously alleges that that Act now governs the review of the Tax Court's decisions, citing *Lincoln Electric Co.* v. *Commissioner,* 162 F. 2d 379 (C.C.A. 6th), and *Dawson* v. *Commissioner,* 163 F. 2d 664 (C.C.A. 6th). (Pet. Br. 20-22.)

In the first place, the granting of or refusing to grant motions such as the taxpayer's herein is, as in the case of motions for rehearing, etc., solely within the sound discretion of the Tax Court in the absence of clear abuse of discretion. *McCarthy* v. *Commissioner,* 139 F. 2d 20 (C.C.A.

7th); *Skenandoa Rayon Corp.* v. *Commissioner,* 122 F. 2d 268 (C.C.A. 2d), certiorari denied, 314 U. S. 696; *Freeman-Hampton Oil Corp.* v. *Commissioner,* 65 F. 2d 456 (C.C.A. 5th); *Jankowsky* v. *Commissioner,* 56 F. 2d 1006, 1010 (C.C.A. 10th); *Rubel* v. *Commissioner,* 74 F. 2d 27 (C.C.A. 6th); *Commissioner* v. *Sussman,* 102 F. 2d 919 (C.C.A. 2d); *Tonopah Mining Co.* v. *Commissioner,* 127 F. 2d 239 (C.C.A. 3d). Cf. *Todd* v. *Commissioner,* 153 F. 2d 553 (C.C.A. 9th). The taxpayer has shown no abuse of discretion on the part of the Tax Court herein.

Next, the Sixth Circuit's reference to the Administrative Procedure Act as having broadened its power to review the Tax Court's decisions, without so deciding, in the *Lincoln Electric Co.* case, *supra,* was clearly dictum in that the decision therein turned on the authority of *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, as the taxpayer suggests. (Br. 22.) In any event, the Administrative Procedure Act does not alter the extent and scope of review of Tax Court decisions for the reason that Section 10 (e) (B) (5) thereof, relating to judicial review and permitting the reviewing court to reverse "agency" findings and conclusions which are "unsupported by substantial evidence", is no broader than the "substantial evidence" rule in respect of factual questions which has been consistently applied by the courts to the review of Tax Court decisions both before and after the decision in *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231, was handed down. See *Commissioner* v. *Scottish American Co.,* 323 U. S. 119; *Helvering* v. *Kehoe,* 309 U. S. 277. Hence that section of the Administrative Procedure Act does not apply any new standards to the review of fact questions and clearly not in the case of Tax Court decisions because Congress had already adopted detailed provisions concerning the authority of the Tax Court and the conduct of its proceed-

ings (Sections 1100-1121 of the Internal Revenue Code (26 U.S.C. 1940 ed., Secs. 1100-1121)), and had already specified the manner in which its decisions shall be reviewed (Sections 1141-1142 of the Internal Revenue Code (26 U.S.C. 1940 ed., Secs. 1141-1142)), without giving any indication that the Administrative Procedure Act is to supersede or to be applied concurrently with those long-established provisions of the Internal Revenue Code.

With all due deference to the court's dictum in the *Lincoln Electric Co.* case to the effect that the Administrative Procedure Act governs review of the Tax Court's decisions, therefore, we nevertheless think that the Act applies only to "agency" actions, and Section 2 (a) thereof clearly excludes the "courts" from the definition of "agency". While the Tax Court is not legally or technically a court, it is clear from the provisions of that Act and its legislative history, particularly Section 5 (relating to "Adjudication") and Section 10 (relating to "Judicial Review"), that it is not an "agency" to which Section 8 or any other section of the Act applies. Apropos of this, the court appropriately stated in *Lawton* v. *Commissioner,* 165 F. 2d 380 (C.C.A. 6th), as follows (p. 383):

> "* * we are not presently concerned with the question whether review of the Tax Court's decisions is governed by the Administrative Procedures Act, 5 U.S.C.A. Sec. 1001 et seq., adverted to in our case of *Lincoln Electric Co.* v. *Commissioner,* 6 Cir., 162 F. (2d) 379.

Likewise, it is unnecessary to decide whether the Administrative Procedure Act applies in this case since the Tax Court's decision is clearly correct under the authorities cited as well as under any theory of judicial review. See *Dawson* v. *Commissioner, supra; Credit Bureau of Greater N. Y.* v. *Commissioner,* 162 F. 2d 7, 9 (C.C.A. 2d).

CONCLUSION

The decision of the Tax Court is correct and in accordance with law and the authorities. It should therefore be affirmed upon review by this Court.

Respectfully submitted,

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March, 1948.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) [As amended by Sec. 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

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(26 U. S. C. 1940 ed., Sec. 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (*a*)-1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business * * *.

SEC. 19.23 (*a*)-6. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not

deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. * * *

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(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

SEC. 19.23 (a)-8. *Bonuses to employees.*—Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income.

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